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No. 94

In the Supreme Court of the United States

October Term, 1942

Mother Lode Coalition Mines Company, petitioner

v.

Guy T. Helvering, Commissioner of Internal Revenue

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

INDEX

CITATIONS

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PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL
REVENUE

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 11–20), is reported in 42 B. T. A. 596. The opinion of the circuit court of appeals (R. 85–90) is reported in 125 F. (2d) 657.

JURISDICTION

The judgment of the circuit court of appeals was entered February 21, 1942 (R. 90–91). The petition for a writ of certiorari was filed May 19, 1942, and granted June 8, 1942. The jurisdiction of this

Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether its income tax return for 1934 reporting gross income but no net income from a mining property was the "first return" made by petitioner under the Revenue Act of 1934 "in respect of" such "property" within the meaning of Section 114 (b) (4) of that Act.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 21–29.

STATEMENT

Petitioner is a corporation operating a metal mining property near Kennecott, Alaska (R. 12). During the years prior to 1933 petitioner had taken deductions on account of depletion which exhausted its cost basis (R. 12, 44). In its income tax return for 1933 it elected "to deduct depletion on the percentage basis for the year 1933 and thereafter" (R. 12). This election was made in accordance with Section 114 (b) (4) of the Revenue Act of 1932 which, for the first time, allowed mining companies to take depletion deductions either for a portion of the cost of the property or for a percentage of the gross income.

The Revenue Act of 1934, applicable to the taxable year here involved, again gave mining com-

panies this election, and provided that the election for 1934 and ensuing years should be made in the following manner (Section 114 (b) (4)):

> A taxpayer making his first return under this title in respect of a property shall state whether he elects to have the depletion allowance for such property for the taxable year for which the return is made computed with or without regard to percentage depletion, and the depletion allowance in respect of such property for such year shall be computed according to the election thus made. If the taxpayer fails to make such statement in the return, the depletion allowance for such property for such year shall be computed without reference to percentage depletion. The method, determined as above, of computing the depletion allowance shall be applied in the case of the property for all taxable years in which it is in the hands of such taxpayer * * *.

Petitioner filed an income-tax return for 1934 and did not state that it elected to take percentage depletion (R. 14). It did report a total income of $27,865.12 (R. 13) which arose from the sale of ore mined the previous year (R. 12, 13). It also reported total deductions of $66,763.38, most of which were due to "Shutdown Expense" (R. 13)—during 1934 petitioner had not extracted ore from the property (R. 12). Consequently, this return showed a net loss and petitioner did not claim any deduction for depletion.

In 1935 petitioner mined its properties and derived a net profit from the operation (R. 12). In its return for 1935 it claimed a deduction of $25,-276.88 for percentage depletion, stating in support of the claim (R. 12):

> Under the provisions of Section 114 (b) (4) of the Revenue Act of 1932 the taxpayer elected to deduct depletion on the percentage basis for the year 1933 and thereafter.

The Commissioner disallowed the percentage depletion deduction for 1935, ruling that under Section 114 (b) (4) of the Revenue Act of 1934 petitioner's failure to make an affirmative election in its 1934 return constituted an election to compute depletion thereafter without reference to percentage depletion (R. 14–15).

Petitioner appealed to the Board of Tax Appeals. The Board found the facts above stated (R. 11–15) and approved the Commissioner's determination of a deficiency based upon disallowance of the deduction (R. 20). Petitioner then appealed to the Circuit Court of Appeals for the Second Circuit, which affirmed the decision of the Board (R. 90). The court held that petitioner's 1934 return was its first return under the Revenue Act of 1934 in respect of the property, regardless of whether it had reported net income, and that the petitioner, having failed to make an affirmative election to take percentage depletion in its return for 1934, could not make such an election in its return for 1935.

On June 8, 1942, this Court granted certiorari limited to this issue,[1] on which the decision below was in conflict with the decision of the Circuit Court of Appeals for the Third Circuit in *Pittston-Duryea Coal Co.* v. *Commissioner*, 117 F. (2d) 436.

SUMMARY OF ARGUMENT

Section 114 (b) (4) of the Revenue Act of 1934 provided that a taxpayer making its "first return" under the income tax title of that Act "in respect of" a property, should state whether he elected the cost or percentage method of computing depletion allowances for that year and for all future years. It also provided that if no election were stated, the allowances should then and thereafter be computed without reference to the percentage method. Petitioner's income tax return for 1934 was its first return made under the income tax title of the Revenue Act of 1934. It was also a return "in respect of" the property for it included items of gross income arising from the sale of ore mined at the property in prior years and items of deduction incurred at the property in 1934. In its 1934 return petitioner did not elect to compute depletion on the percentage method. Therefore, the

[1] The court below also held that the election stated in the taxpayer's 1933 return was not sufficient for subsequent years because Section 114 (b) (4) of the Revenue Act of 1934 required a new election to be made in the first return filed under that Act (R. 86–88). Taxpayer challenged this holding in its petition for certiorari but in granting the writ this Court excluded further argument on the point.

Commissioner was required by the plain words of the statute to require any future deduction for depletion to be computed without reference to the percentage method.

The applicable Treasury regulation is equally explicit. It defines a return made in respect of a property as one showing any item of income or deduction with respect to a property. Petitioner's return showed income from ore mined at the property in previous years and deductions for expenditures incurred in 1934 with respect to maintenance of the property. Therefore, the return was the first return "in respect of" the property and petitioner was required to state its election at that time, regardless of whether it had a net income.

In following the plain meaning of the words and applying the governing Treasury regulation the court below made effective the only fair and practicable interpretation of Section 114 (b) (4). To interpolate any further qualification such as the one petitioner suggests would be unfair as between taxpayers by giving some an opportunity to postpone their decision later than their competitors. It would also be unworkable because neither the Commissioner nor the taxpayer could identify the return in which the election should be made until it was ascertained, perhaps years later after protracted litigation, whether or not the taxpayer in 1934 had had net income.

ARGUMENT

PETITIONER'S INCOME TAX RETURN FOR 1934 WAS THE "FIRST RETURN" MADE BY TAXPAYER UNDER THE REVENUE ACT OF 1934 "IN RESPECT OF" ITS MINING PROPERTY

Section 114 (b) (4) of the Revenue Act of 1934 (pp. 22–23, *infra*) set forth in detailed and explicit terms the manner in which mining companies should elect whether to take depletion for all subsequent years on a cost or a percentage basis. The section required that "a taxpayer making his first return under this [the income tax] title in respect of a property" should state which basis he selected, and it provided that the allowance should be calculated in accordance with the election stated. It will be observed that what was required to be stated was the choice of a *method* of computing the allowance.

Section 114 (b) (4) also covered the case of those who did not expressly state an election; it provided that "If the taxpayer fails to make such statement in the return, the depletion allowance for such property for such year shall be computed without reference to percentage depletion." The next sentence made binding for subsequent years the election made for 1934: "The method, determined as above, of computing the depletion allowance shall be applied in the case of

the property for all taxable years in which it is in the hands of such taxpayer * * *."[2]

Although depletion allowances are normally made to permit owners of wasting property to recover their cost (*Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, 366–367), these provisions for percentage depletion created a specially privileged class of taxpayers who continued to receive depletion allowances after one hundred percent of their cost had been recovered.[3] The petitioner had exhausted its cost basis and if it desired to bring itself within the privileged class the burden was upon it to do so by stating its election in its first income tax return made under the Revenue Act of 1934 in respect of its property. For this liberal offer of legislative grace is to be strictly construed and limited to those who meet the statutory terms. Cf. *Riley Co.* v. *Commissioner*, 311 U. S. 55. See also *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440; *White* v. *United States*, 305 U. S. 281, 284; *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49.

[2] Section 114 (b) (4) of the Revenue Acts of 1936 and 1938 and of the Internal Revenue Code gave continuing effect to this provision. The Revenue Act of 1942 permits the taxpayer to take either cost or percentage depletion, whichever is greater, without regard to any previous election. Public Law 753, 77th Cong., 2d Sess., approved October 21, 1942.

[3] See the Statement of Secretary Morgenthau, Hearings before the Committee on Ways and Means, House of Representatives, on Revenue Revisions of 1942, 77th Cong., 2d Sess., pp. 8–9, recommending the abolition of this "special privilege."

In the instant case petitioner failed to meet the terms of the offer. It filed an income tax return for 1934 showing gross income from ore mined in previous years at the property and claiming deductions on account of such items as "Shutdown Expense" at the property, but it did not state in the return that it elected to take percentage depletion. Under the statutory language quoted above it was bound to do so, for the 1934 return was petitioner's "first return" made under the income tax title of the Revenue Act of 1934 "in respect of" the property on account of which it now claims the depletion allowance.

Certainly, the 1934 return was the "first return." Petitioner had not previously filed a return under that title, and did file this return under that title.

It is equally clear that petitioner's 1934 return was filed "in respect of" the property. During 1934 petitioner sold ores which it had mined in prior years from the property in question. The 1934 return, made upon the inventory basis of accounting, showed a gross profit of \$27,690.36 from the sale of these ores (R. 13). This profit was "gross income from the property" even though there was no production for the year (*Herring* v. *Commissioner*, 293 U. S. 322). Interest and rents received increased the taxpayer's total income to \$27,865.12 (R. 13). The deductions aggregated \$66,763.38 (R. 13). They included an item of \$41,-369.94 listed as "Shutdown Expense," all or a

part of which was incurred in respect of the property (R. 12, 13). There was a net loss of $38,898.26 (R. 13). But whatever the net result, the return, which included these items of income produced by the mine, together with the offsetting items of deductions from the same source, was plainly made "in respect of" that "property."

Finally, petitioner could have stated in the 1934 return whether it elected to have its depletion allowance computed according to the cost or the percentage method. Both methods would have resulted in an allowance of zero but that could not be known until the computation was made; the statement could have been made and it would have served a reasonable purpose (see pp. 15-19 *infra*).

For these reasons, under the plain words of the statute, taxpayer's 1934 return falls within the statutory description, and its failure then to state its election foreclosed any subsequent claim to percentage depletion.

Likewise, Article 23 (m)-5 of Treasury Regulations 86, promulgated under the Revenue Act of 1934, makes plain that petitioner was bound to state in its 1934 return any election which it wished to make to take depletion deductions for future years on the percentage basis. Article 23 (m)-5 provides:

> In his first return made under Title I of the Act (for a taxable year beginning after December 31, 1933) the taxpayer must state *as to each property with respect to which*

> *the taxpayer has any item of income or deduction* whether he elects to have the depletion allowance for each such property for the taxable year computed with or without reference to percentage depletion. * * * *If the taxpayer fails to make* such statement in the return in which the election should be so indicated, *the depletion allowance* for the year for which an election must be first exercised and for all succeeding taxable years *will be computed without reference to percentage depletion.* * * * [Italics supplied.]

Petitioner's 1934 income tax return covered its first taxable year beginning after December 31, 1933. It had items both of income and of deduction with respect to the property. Its silence left Commissioner no alternative except to compute the deductions for subsequent years without reference to percentage depletion.

The regulation is binding if valid. *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90; *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326. And it is plainly valid; for if the words of Section 114 (b) (4) do not compel the rule expressed in it, then they are an appropriate subject for an interpretative regulation. Cf. *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326; *Magruder* v. *Washington, Baltimore & Annapolis R. Corp.*, 316 U. S. 69. Article 23 (m)-5 gives the words a reasonable interpretation which, as we shall show below, is fair and practical in its operation. Moreover,

since its promulgation the statutory language has several times been reenacted, thus reinforcing its validity. *Morrissey* v. *Commissioner,* 296 U. S. 344, 355. Cf. *Morgan* v. *Commissioner,* 309 U. S. 78, 81; *Old Mission Co.* v. *Helvering,* 293 U. S. 289, 293, 294; *Helvering* v. *Winmill,* 305 U. S. 79, 83. The remarks of Representative Disney quoted by petitioner (Br. 16) do not detract from the force of the successive reenactments. The committee rejected his amendment which would have written the petitioner's interpretation into the statute with the explanation that the amendment clarified the original intent. Consequently, if any inference may be drawn from the event, it is that Representative Disney's interpretation of the original intent was erroneous.[4]

In the face of the language of the statute and of the applicable Treasury regulations, petitioner seeks to enlarge the special privilege created by Section 114 (b) (4) to permit taxpayers to make the election in a second income tax return filed in respect of a property wherever the first return correctly shows that the taxpayer had no net income. The petitioner's argument for that result is as follows: The statute requires the taxpayer to state in its first return whether it elects to have "the depletion allowance for such property for the taxable year for which the return is made com-

[4] The changes made in Section 114, and the House and Senate reports explaining them, are manifestly irrelevant. See p. 8, n. 2, *supra.*

puted with or without regard to percentage depletion" and then provides that "the depletion allowance * * * shall be computed according to the election thus made"; therefore, petitioner says (Br. 9), "the first return" must be "one in which the petitioner could elect to have the 'depletion allowance * * * for the taxable year' computed with or without reference to percentage depletion"; and, petitioner continues, in its 1934 return the petitioner could not so elect because it had no net income.

The argument is manifestly fallacious; and the fault lies in the final step. Petitioner could have elected in 1934 whether to have the depletion allowance for 1934 "computed with or without regard to percentage depletion," and the computation of the allowance could have been made according to the method thus chosen. It so happened that either method of making the computation would result in no allowance, so that the choice had no significance for that year, but that could not be known until the computation was completed. Other taxpayers might be able to take a deduction according to one method and not the other, or according to either method. Often the result could not be known until, first, the method had been selected and, second, the computation had been made. But every taxpayer, regardless of his situation, could choose one or the other method of making the computation, even though he might take no deduction. This is all that the statute re-

quires and the Treasury interpretation gives full scope and meaning to every word in it. Conversely, there is nothing in the statute which even suggests that the election of a method of computation was not to be made until the computation would result in an actual deduction. The choice to be made was between *methods* of computation.[5]

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[5] As pointed out in the text the Treasury interpretation gives effect to every word in Section 114 (b) (4) and, as we shall show, it is reasonable. (See pp. 15–19, *infra.*) Petitioner's arguments, when exposed, go only to contend that Section 114 (b) (4) should be interpreted to speak of an election between two actual deductions, or between an actual deduction and no deduction. At most, they would show that there is a reasonable interpretation other than that which the Treasury adopted. But this, it is settled, is not enough to overthrow the Treasury regulation.

In fact, however, analysis of petitioner's argument and of *Pittston-Duryea Coal Co.* v. *Commissioner*, 117 F. (2d) 436 (C. C. A. 3), shows the weakness of the view which they advance. Petitioner argues (Br. 4, 7–8) that the first return is "the first in which the taxpayer has an election between cost and percentage depletion." But after its decision in the *Pittston-Duryea* case, the Circuit Court of Appeals for the Third Circuit itself recognized this argument was often unsound. In *Tonapah Mining Co.* v. *Commissioner*, 127 F. (2d) 239 (C. C. A. 3), the taxpayer had exhausted its cost basis before 1934 and therefore in that year could not have elected between deductions on the cost or percentage basis. Nevertheless, the court held that the taxpayer was not excused from stating its election in its 1934 return.

Petitioner also argues (Br. 10–11), adopting the view of the Circuit Court of Appeals for the Third Circuit, that Congress cannot have intended to require a taxpayer to make a choice at a time when there could be no depletion allowance; there could be no allowance, the court said, unless there was net income; "one may not in making an income

In addition to being a reasonable interpretation of the words, the Treasury regulation gives effect to two fundamental purposes of Section 114 (b) (4), which cannot be accomplished under petitioner's interpretation. First, Section 114 (b) (4) aims to put all taxpayers on an equal basis in choosing a program for depletion by requiring each to make its election concurrently with its competitors. Second, the Commissioner's interpretation will simplify administrative procedure and avoid the administrative confusion which, it is demonstrable, would follow from acceptance of the petitioner's interpretation.

First: The purpose of Section 114 (b) (4) was to give taxpayers an opportunity to elect not a depletion deduction but a depletion program. Al-

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tax return use the subtrahend of deduction unless he has a minuend of net income from which to subtract it." *Pittston-Duryea Coal Co.* v. *Commissioner*, 117 F. (2d) 436, 438. The fallacy of this argument is pointed out by the court below (R. 89); it does not meet the case of a taxpayer who had no net income in 1934 and no right to percentage depletion but who did have gross income and a depletable cost. Even under petitioner's view, a taxpayer in that position would have been able to take a depletion deduction and would therefore have been put to its election in 1934. In such a case the existence of net income is immaterial, for the depletion deduction is not subtracted from net income but from gross income; provision is made for it, as for most other deductions, in Section 23 of the Revenue Acts and no one of these permitted deductions is any more or less available than the others even though a part of them may exceed the gross income.

though the initial sentences are cast in terms of electing a method for computing a current deduction, other provisions make the choice binding in subsequent years. As a result, a taxpayer making a return for 1934 ordinarily would be concerned less with making a mathematical computation to determine the largest deduction for that year than with selecting the method of computing depletion. A taxpayer planning large capital expenditures in the hope of securing modest earnings might elect to use the cost basis even though it could secure a larger deduction for 1934 by using the percentage method. In the case of other taxpayers the converse situation doubtless existed. The point to be emphasized is that the election provided for by Section 114 (b) (4) had more future than current importance.

In view of that circumstance there is little reason to suppose that Congress considered it at all important whether a taxpayer could make a return for 1934 showing no net income without making a claim for a depletion deduction. To have made that fact decisive would have been grossly unfair to other companies for it would have given companies situated as petitioner an additional year in which to study conditions, make plans, and form a conclusion as to how to secure a tax advantage. Consequently, it is far more reasonable to suppose that Congress intended to treat all taxpayers alike and to require all who were making returns in 1934 in any way relating to a mining property

to choose at that time their depletion programs.[6]

Second: The petitioner has not stated precisely what interpretation it would place upon Section 114 (b) (4) but has left it uncertain whether the actual existence of net income before a depletion deduction is to be decisive or whether the critical fact is to be what is shown on the face of the original return. We assume that petitioner prefers the former alternative, which was adopted by the Circuit Court of Appeals for the Third Circuit. *Kehoe-Berge Coal Mining Co.* v. *Commissioner,* 117 F. (2d) 439. The latter would make the obligation to state an election dependent, at least in part, on the errors of the taxpayer, a consequence which Congress surely did not intend.

But the view adopted in the *Kehoe-Berge* case is unsound in practice. Under that interpretation, whether a taxpayer was put to its election in its 1934 return or could make the election later, could not be known until a final determination was made some years later, perhaps after protracted litigation concerning whether or not the taxpayer in 1934 had net income. Such a result would be unfair to taxpayers and to the Government.

[6] Petitioner argued in the court below that a farmer making a return in respect of his farm property in 1934 should not be obliged to elect how to compute depletion in order to be able to take depletion on a percentage basis in future years in the event that minerals are discovered on the property. The example is not in point. The reason the farmer would not be required to state the election is that his 1934 return was not made in respect of a mining property and not that there was no net income from mining operations.

Under this interpretation many taxpayers would not know until too late whether or not they were required to state an election in the 1934 return. For example, in the *Kehoe-Berge* case the 1934 return erroneously showed no net income and the taxpayer did not state its election to take percentage depletion until 1935 when the taxpayer had net income. Had the 1934 return been correct, as the taxpayer doubtless believed it to be, its election made in the 1935 return would have been adequate under petitioner's theory; but since it later developed that taxpayer had net income for 1934 the claim of percentage depletion made for 1935 came too late.

Such a result also would be administratively unworkable, as a simple example will make clear. Let us suppose that a taxpayer makes a 1934 return showing a net loss, in which it takes no deduction for depletion and makes no election. Later, the Commissioner assesses a deficiency, contending that certain income not returned was taxable; the taxpayer disputes his ruling and litigation follows. Until that litigation was finally decided, neither the taxpaper nor the Bureau of Internal Revenue could tell whether the taxpayer was put to an election in 1934, and by silence had bound itself to the cost method, or whether it could make the election in a later year. Meanwhile, the taxpayer could not intelligently plan its operations or know its financial condition, and the Bureau would be compelled to keep open all the

returns for subsequent years in order to check the later depletion deductions.[7]

To this confusion is to be compared the simple administrative procedure possible under the Treasury interpretation. As the court below said, after discussing the problems illustrated by the *Kehoe-Berge* case (R. 89–90):

> Section 114 (b) (4) will be much simpler in administration under the commissioner's interpretation. Tax officials will look first to the taxpayer's 1934 return. If this reports items of gross income from a mining property they need look no further to ascertain the method of computing depletion allowance for such property in future years; if it does not, then they must find the "first return in respect of" such property in some later year. * * *

In view of the contrast in the practical operation of the two alternatives we can perceive no justification for doubting the validity of the applicable Treasury regulation.

CONCLUSION

The decision below follows the plain meaning of the words of Section 114 (b) (4). In re-

[7] Petitioner's suggestion (Br. 14) that taxpayers would refer to the return in which the election was made, thus guiding the Commissioner, obviously does not meet the administrative difficulty discussed above. Neither would it avail the Commissioner anything in the years after 1934 to check the return for the previous year.

fusing to extend the special privilege created by the section to the petitioner, which failed to bring itself within the words of the statute, the court gave proper effect to an explicit Treasury regulation admittedly applicable to the case. The conclusion reached was fair and administratively sound. Therefore, the decision should be affirmed.

Respectfully submitted.

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NOVEMBER 1942.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent

provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion allowable under this subsection, see section 114 (b), (3), and (4).)

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

(1) *General rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

(4) *Percentage depletion for coal and metal mines and sulphur.*—The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 15 per centum, and, in the case of sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion)

from the property. A taxpayer making his first return under this title in respect of a property shall state whether he elects to have the depletion allowance for such property for the taxable year for which the return is made computed with or without regard to percentage depletion, and the depletion allowance in respect of such property for such year shall be computed according to the election thus made. If the taxpayer fails to make such statement in the return, the depletion allowance for such property for such year shall be computed without reference to percentage depletion. The method, determined as above, of computing the depletion allowance shall be applied in the case of the property for all taxable years in which it is in the hands of such taxpayer, or of any other person if the basis of the property (for determining gain) in his hands is, under section 113, determined by reference to the basis in the hands of such taxpayer, either directly or through one or more substituted bases, as defined in that section.

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23 (m)-1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under these provisions of the Act the owner of an interest in mineral deposits,

mineral properties, or timber, whether freehold or leasehold, is allowed annual depletion and depreciation deductions which, in the aggregate, will return to him the cost or other basis of such property as provided in section 113, plus, in either case, subsequent allowable capital additions (see articles 23 (m)–15 and 23 (m)–16) with the following exceptions and qualifications:

* * * * *

(2) In the case of coal mines, metal mines, and sulphur mines or deposits the aggregate annual allowable deductions may never be as great as the cost or other basis, if an election of the percentage depletion method is made in his first return under Title I of the Act; and

* * * * *

When used in these articles (23 (m)–1 to 23 (m)–28) covering depletion and depreciation—

* * * * *

(g) "Gross income from the property" as used in section 114 (b) (3) and (4) and articles 23 (m)–1 to 23 (m)–28, inclusive, means the amount for which the taxpayer sells (a) the crude mineral product of the property or (b) the product derived therefrom, not to exceed in the case of (a) the representative market or field price (as of the date of sale) of crude mineral product of like kind and grade before transportation from the immediate vicinity of the mine or well, or in the case of (b) the representative market or field price (as of the date of sale) of a product of the kind and grade from which the product sold was derived, before the application of any processes (to which the crude mineral product

may have been subjected after emerging from the mine or well) with the exception of those listed below, and before transportation from the place where the last of the processes listed below was applied. If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes minus the costs (including transportation costs) of the processes not listed below. The processes excepted are as follows:

(1) In the case of coal—cleaning, breaking, sizing, and loading at the mine for shipment;

(2) In the case of sulphur—pumping to vats, cooling, breaking, and loading at the mine for shipment;

(3) In the case of iron ore and ores which are customarily sold in the form of the crude mineral product—sorting or concentrating to bring to shipping grade, and loading at the mine for shipment; and

(4) In the case of lead, zinc, copper, gold, or silver ores and ores which are not customarily sold in the form of the crude mineral product—crushing, concentrating (by gravity or flotation), and other processes to the extent to which they do not beneficiate the product in greater degree (in relation to the crude mineral product on the one hand and the refined product on the other) than crushing and concentrating (by gravity or flotation).

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the

taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments or advanced royalties (see article 23 (m)-10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year.

(h) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114 (b) (2), (3), and (4) and articles 23 (m)-1 to 23 (m)-28, inclusive, means the "gross income from the property" as defined in paragraph (g) less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (g) insofar as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. To illustrate: In cases where the taxpayer engages in activities in addition to mineral extraction and to the processes listed in paragraph (g), deductions for depreciation, taxes, general expenses, and overhead, which cannot be directly attributed to any specific activity, shall be fairly apportioned between (1) the mineral extraction and the processes listed in paragraph (g) and (2) the additional

activities, taking into account the ratio which the operating expenses directly attributable to the mineral extraction and the processes listed in paragraph (g) bear to the operating expenses directly attributable to the additional activities. If more than one mineral property is involved, the deductions apportioned to the mineral extraction and the processes listed in paragraph (g) shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

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ART. 23 (m)–5. *Computation of depletion based on a percentage of income in the case of coal mines, metal mines, and sulphur mines or deposits.*—Under section 114 (b) (4) a taxpayer may deduct for depletion an amount equal to 5 per cent of the gross income from the property during the taxable year in the case of coal mines, an amount equal to 15 per cent of the gross income from the property during the taxable year in the case of metal mines, and an amount equal to 23 per cent of the gross income from the property during the taxable year in the case of sulphur mines or deposits, but such deduction shall not in any case exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see article 23 (m)–1 (g) and (h).)

In his first return made under Title I of the Act (for a taxable year beginning after December 31, 1933) the taxpayer must state as to each property with respect to which

the taxpayer has any item of income or deduction whether he elects to have the depletion allowance for each such property for the taxable year computed with or without reference to percentage depletion. An election once exercised under section 114 (b) (4) and this article cannot thereafter be changed by the taxpayer, and the depletion allowance in respect of each such property will for all succeeding taxable years be computed in accordance with the election so made. If the taxpayer fails to make such statement in the return in which the election should be so indicated, the depletion allowance for the year for which an election must be first exercised and for all succeeding taxable years will be computed without reference to percentage depletion. The method, determined under section 114 (b) (4) and this article, of computing the depletion allowance shall be applied in the case of the property for all taxable years in which it is in the hands of such taxpayer, or of any other person if the basis of the property (for determining gain) in his hands is, under section 113, determined by reference to the basis in the hands of such taxpayer, either directly or through one or more substituted bases, as defined in that section.

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ART. 114–1. *Basis for allowance of depreciation and depletion.*—The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, except as pro-

vided in article 23 (m)-3, relating to depletion based on discovery value, in article 23 (m)-4, relating to percentage depletion in the case of oil and gas wells, and in article 23 (m)-5, relating to percentage depletion in the case of coal mines, metal mines, and sulphur mines or deposits.

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